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No. 99-1834

In the Supreme Court of the United States

KENCO RESTAURANTS, INC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, pursuant to 26 U.S.C. 482, the Commissioner of Internal Revenue properly reallocated deductions among commonly controlled corporations to reflect arm's length charges for services performed by a related corporation.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-17a) is reported at 206 F.3d 588. The opinion of the United States Tax Court (Pet. App. 18a-35a) is unofficially reported at 76 T.C.M. (CCH) 512.

JURISDICTION

The judgment of the court of appeals was entered on February 16, 2000. The petition for a writ of certiorari was filed on May 16, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners Kenco Restaurants, Inc., K-K Restaurants, Inc., Tiffin Avenue Realty Co., Inc., and Bryan

Realty, Inc., are members of a group of 14 corporations that are owned in equal shares by three shareholders (individually or together with their wives). Those shareholders are George Kentris, his father, Mike Kentris, and Ken Baerwaldt. Pet. App. 2a-3a. Seven of the corporations (the restaurant corporations) own and operate Taco Bell restaurants. Six of the corporations (the realty corporations) own the real estate where the restaurants are located. *Id.* at 3a; C.A. App. 51-53. The fourteenth corporation, BKK Management, Inc., provided management and administrative services to the other 13 corporations during 1990, 1991 and 1992. Pet. App. 3a, 20a. The services provided by BKK Management were performed by the three owners and by additional employees, all of whom received salaries from BKK. *Id.* at 4a. BKK Management provided similar services to each corporation—accounting and administrative services, operational oversight, product pricing, advertising and training. *Id.* at 3a, 20a.

BKK Management charged each of the 13 related corporations a "management cost share" fee for its services. These fees ranged from a high of $413,000 charged to Kenco in 1991 (more than 42% of the total fees for that year) to zero for the Wapak restaurant in 1990. Pet. App. 4a. Petitioners claim that the fee allocations for management services were based on the number of hours the owners devoted to each corporation. The owners did not, however, maintain records of the number of hours actually spent on each corporation during any given year. The owners instead projected the number of hours they would spend on each corporation for the next year, based on the number of hours allegedly devoted to each corporation during the previous year, and made adjustments to those esti-

mates for any specific projects contemplated for the coming year. *Ibid.*

Upon audit of petitioners' returns for 1990, 1991 and 1992, the Commissioner of Internal Revenue determined that the fees paid to BKK Management did not reflect an arm's length charge for its services. In cases involving commonly controlled corporations, the Commissioner is authorized by Section 482 of the Internal Revenue Code to make such allocations or distributions of income and deductions among such corporations as he determines "is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations * * *." 26 U.S.C. 482. Invoking that authority, the Commissioner reallocated the management fees among the various commonly controlled corporations to reflect arm's length charges in their dealings with one another. This reallocation of deductions and income resulted in tax deficiencies for some of the corporations. Petitioners filed petitions in Tax Court seeking review of the deficiency determinations. Pet. App. 27a-28a.

2. In the Tax Court proceedings, petitioners engaged an accounting expert to render an opinion on the reasonableness of the management fee allocations. The Tax Court refused to admit the accountant's report, however, because he was not qualified as an expert in the field of determining reasonable management fees. C.A. App. 593.

At trial, the government introduced the testimony of the revenue agent who had conducted the audit. The agent had reallocated BKK's management fees among the restaurant corporations primarily based upon the gross sales of each corporation. Adjustments were made in that allocation formula for the realty corporations that made no sales. Pet. App. 6a. The agent

used a gross sales reallocation method because petitioners did not provide time logs or any other documentary basis for calculating the actual number of hours devoted by the owners to each corporation. *Id.* at 6a, 17a, 29a. The agent testified that petitioners' accountant had stated that her allocation of the payments made by the corporations to BKK for management services was based on the "cash flows" of each corporation. C.A. App. 596, 611. Petitioners' accountant, however, testified that the agent's recollection was a "misunderstanding" and that the allocation was based on the costs of providing the management services, not on the income of the client corporations. *Id.* at 708.

The government also called a business valuation expert whose allocations of the management fees were based on a different method than that reflected in the notice of deficiency.[1] In the opinion of that expert, the fee allocations made by petitioners were not consistent with the fees that each corporation would have paid for management services in an arm's-length transaction. She devised arm's length allocations by calculating the amount of time each owner and employee of BKK spent performing particular services at each restaurant. She obtained data for these calculations from interviews with the owners and employees regarding their particular duties and responsibilities. She did not accord greater weight to the owner hours than the employee hours because owners and employees often spent time performing similar tasks. She concluded that this allocation of management fees based on the total hours

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[1] This expert witness did not analyze or reallocate any portion of the fees attributable to the realty corporations, nor did she reallocate any portion of the fees to Bryan Restaurants, Inc., which was created during 1992. Pet. App. 7a-8a.

of services provided to each corporation more clearly reflected the arm's-length charges attributable to such services than was yielded by petitioners' original allocation method. Pet. App. 7a.

3. The Tax Court found that petitioners failed to prove that the Commissioner's reallocation of the management charges was arbitrary, capricious or unreasonable. Pet. App. 29a-31a. The court noted that, although petitioners contended that their own method of allocating management fees among the corporations was reasonable, "they have not directed any of their argument to proving that [the revenue agent's] method produces an arbitrary, capricious, or unreasonable result, to wit, that gross sales is not indicative of management and administrative services provided." *Id.* at 29a. Although petitioners criticized the agent for failing to take into account "certain unusual events" that required BKK to provide "unusual types and amounts of services" to the affected corporations, the Tax Court concluded that the failure of the owners to maintain records regarding hours spent "made it impossible for [the agent] to determine the impact of the unusual events on the services provided using an hour-based allocation methodology." *Ibid.* The Tax Court observed that petitioners' "principal engagement at trial and on brief" (*id.* at 30a) was disputing the management fee reallocation made by the government's business valuation expert, rather than the allocation contained in the deficiency notices, under a mistaken belief that the Commissioner had abandoned the notice of deficiency. The court concluded that the Commissioner had not abandoned the deficiency determination but had relied on the expert's testimony "only to prove a reasonable allocation on the contingency that petitioners succeed in showing the respondent's allocation to be arbitrary,

capricious, or unreasonable." *Id.* at 30a-31a. The court held that the Commissioner's reallocation of these costs was an appropriate exercise of his authority under Section 482 clearly to reflect the income of the controlled corporations because petitioners had impermissibly allocated the management fees on the basis of ability to pay, rather than on the basis of the costs of services provided. *Id.* at 31a-34a.

4. The court of appeals affirmed. The court first rejected petitioners' contention that they had been relieved of their initial burden of demonstrating that the reallocations in the notice of deficiency were arbitrary, capricious, or unreasonable by the government's supposed abandonment of the allocations contained in the notices of deficiency in favor of the expert witness's reallocations at trial. Pet. App. 9a-10a. The court held that the government "may rely on alternative theories supported by a different methodology than that used in the notice of deficiency" and that such reliance "does not * * * render the notice of deficiency arbitrary, capricious, or unreasonable." *Id.* at 9a. The court also agreed with the Tax Court's finding that respondent had not, in fact, ever abandoned the reallocations contained in the notice of deficiency but had instead relied upon the expert's testimony as an alternative allocation in the event that petitioners met the threshold burden of establishing that the reallocations in the notice of deficiency were wrong. *Id.* at 10a. The court noted that the government "had no reason to establish an arm's-length charge other than as a contingency argument in case Petitioners overcame the initial presumption." *Ibid.*

The court of appeals concluded that petitioners had failed to meet their burden of proving that the reallocations in the notice of deficiency were arbitrary, capri-

cious or erroneous. The court explained that "[p]etitioners provide[d] no evidence of an independent transaction between unrelated parties in similar circumstances," and "the facts support our conclusion that Petitioners were not dealing at arm's length but were, instead, allocating their costs based on an ability to pay." Pet. App. 15a. The court noted that, although one of the restaurant corporations paid no management fee in 1990, its fee increased in 1991 and 1992 as its income rose during those years. *Ibid.* Similarly, the fees charged to another of the corporations increased more than ninefold between 1990 and 1992, and its share of the total fees increased by a factor of seven, without any evidence of "a corresponding increase in Owner hours." *Id.* at 16a.

ARGUMENT

The fact-bound decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. Section 482 of the Internal Revenue Code authorizes the Commissioner to reallocate income or deductions among commonly controlled businesses if he determines that such a reallocation "is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such * * * businesses." 26 U.S.C. 482; see *Eli Lilly & Co.* v. *Commissioner*, 856 F.2d 855, 859 (7th Cir. 1988). The purpose of this statute is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer and to "prevent artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises." *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, 400 (1972) (quoting B. Bittker & J. Eustice, *Federal Income Taxation*

of Corporations and Shareholders at 15-21 (3d ed. 1971)); see also 26 C.F.R. 1.482-1A(a)(1); H.R. Rep. No. 2, 70th Cong., 1st Sess. 16-17 (1928).

In testing dealings between commonly controlled taxpayers under Section 482, the touchstone is that of "an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." 26 C.F.R. 1.482-1A(b)(1); *Bausch & Lomb, Inc.* v. *Commissioner*, 933 F.2d 1084, 1089 (2d Cir. 1991); *Baldwin-Lima-Hamilton Corp.* v. *United States*, 435 F.2d 182, 185 (7th Cir. 1970). When a corporation (such as BKK) renders management or administrative services to related corporations as an "integral part of the business activity," i.e., as "one of its principal activities," 26 C.F.R. 1.482-2(b)(7)(ii), an arm's length charge is "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts." 26 C.F.R. 1.482-2(b)(3).

Recognizing the broad discretion that Congress conferred on the Commissioner to appraise particular fact situations in making a Section 482 allocation, the courts have held that such allocation determinations are not to be set aside unless clearly shown to be arbitrary, capricious or unreasonable. *Eli Lilly & Co.* v. *Commissioner*, 856 F.2d at 860; *Spicer Theatre, Inc.* v. *Commissioner*, 346 F.2d 704, 706 (6th Cir. 1965). To meet this burden, the taxpayer ordinarily produces evidence showing that its dealings are consistent with those entered into by other parties at arm's length. See, *e.g.*, *Central Bank of the South* v. *United States*, 834 F.2d 990, 993-994 (11th Cir. 1987); *Lufkin Foundry & Mach. Co.* v. *Commissioner*, 468 F.2d 805, 807 (5th Cir. 1972); *Wisconsin Big Boy Corp.* v. *Commissioner*, 452 F.2d

137, 139-141 (7th Cir. 1971); see also 26 C.F.R. 1.482-1A(b)(1).

Even if the taxpayer were to prove that the Commissioner's reallocations were arbitrary, capricious or unreasonable, the taxpayer would still bear the ultimate burden of proving that its own allocations reflect arm's length charges. See *Welch* v. *Helvering*, 290 U.S. 111 (1933); Tax Ct. R. 142(a). In that situation, the government would be entitled to provide the court with alternative evidence of arm's length charges to rebut the evidence offered by the taxpayer. *Eli Lilly & Co.* v. *Commissioner*, 856 F.2d at 860. The court would then be able to accept either the evidence offered by the taxpayer, the evidence offered by the government, or instead make its own allocation of the charges. *Id.* at 859-860.

2. The Tax Court and the court of appeals both determined that, on the record of this case, petitioners have failed to satisfy their burden of proving that the Commissioner's reallocation of management fees in the notices of deficiency was arbitrary, capricious or unreasonable. In particular, both courts correctly concluded that petitioners failed to establish the amount of fees that would have been charged for similar management services rendered at arm's length to unrelated corporations. Pet. App. 14a-15a, 29a-30a. There is no basis to disturb these factual conclusions "concurred in by two lower courts" (*Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982)). See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

Petitioners err in contending (Pet. 11-15) that the allocation of the burden of proof in this case conflicts with the allocation described by the Seventh Circuit in *Eli Lilly & Co.* v. *Commissioner*, 856 F.2d at 860. Like the court of appeals in this case (Pet. App. 14a), the

Seventh Circuit in *Eli Lilly* held that the taxpayer must first rebut the presumptive validity of the Commissioner's determinations under Section 482 by establishing that the Commissioner's allocations are arbitrary, capricious or unreasonable. 856 F.2d at 860. In order to show that the Commissioner abused his discretion under Section 482, the taxpayer must show that arm's length transactions among uncontrolled parties are inconsistent with the Commissioner's determinations. A taxpayer challenging a Section 482 allocation is required to "present evidence sufficient to establish that the discounts and commissions it gave would not have varied had one uncontrolled taxpayer dealt at arm's length with another uncontrolled taxpayer" and such proof "is the generally accepted standard of evidence necessary to overcome the presumption of correctness and to establish the arbitrariness of the Commissioner's allocations." *Lufkin Foundry & Mach. Co.* v. *Commissioner*, 468 F.2d at 807 (citing cases). Because petitioners presented no such evidence, they failed to acquit their initial burden of proof in this case.[2]

3. There is also no merit to petitioners' contention (Pet. 17-24) that the Commissioner abandoned the allo-

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[2] "Petitioners' allocations are not an arm's–length charge because Petitioners provide no evidence of an independent transaction between unrelated parties in similar circumstances." Pet. App. 15a. Petitioners contend (Pet. 13) that when a taxpayer *has* rebutted the Commissioner's determinations, the Tax Court could then make a determination of the proper allocation of such charges based upon the totality of the evidence in the record. Since petitioners failed to satisfy their initial burden of establishing that the Commissioner's determinations were arbitrary and capricious, however, neither the Tax Court nor the court of appeals had occasion to attempt a further reallocation of the charges at issue in this case.

cations of management fees that were the basis of the notices of deficiency. As the courts below correctly held, the Commissioner presented the testimony of an expert witness as alternative evidence of an arm's length reallocation of such fees in the event that the taxpayer succeeded in meeting the initial burden of showing the Commissioner's determinations to be arbitrary and capricious. Such evidence was properly submitted "as a contingency argument in case Petitioners overcame the initial presumption." Pet. App. 10a; see also *id.* at 30a-31a. Proffering such alternative evidence of the taxpayer's liability does not constitute an abandonment of notice of deficiency and does not render the notice of deficiency arbitrary, capricious, or unreasonable. *Altama Delta Corp.* v. *Commissioner*, 104 T.C. 424, 458 (1995). See also *Sunstrand Corp.* v. *Commissioner*, 96 T.C. 226, 354-355 (1991).

Petitioners point to selected portions of the trial transcript where the Commissioner's counsel or the Tax Court referred to the evidence provided by the expert witness (Pet. 18-21). At no point, however, did the Commissioner or his counsel state that the government was abandoning the notice of deficiency. Moreover, the question whether an abandonment occurred is inherently a factual matter that the Tax Court was in the best position to evaluate as the events transpired during the course of the trial. See *Anderson* v. *City of Bessemer City*, 470 U.S. 564, 575 (1985). Based upon the record before it, the Tax Court correctly determined that the Commissioner did not abandon the notice of deficiency by presenting an alternative method for allocating these management fees. That factbound determination, concurred in by the court of appeals, does not warrant review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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